

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: External Equity-
Soft Dollar Policy

ITEM NUMBER: 11

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: April 7, 1999

INFORMATION: _____

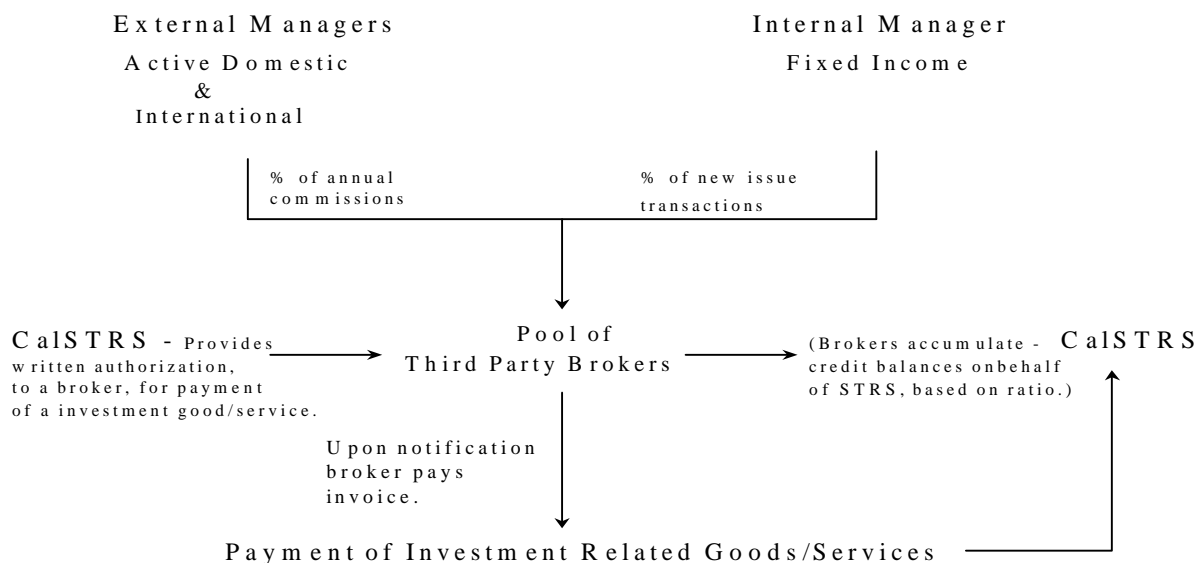
PRESENTER(S) Ms. Okada

EXECUTIVE SUMMARY

The Investment Branch of the California State Teachers' Retirement System (CalSTRS) established a Soft Dollar Program (Program) for the purpose of using a portion of the commissions generated by its managers, to defray expenses which otherwise would have been incurred and paid for using budgeted funds. The term soft dollar refers to the process and the use of these commissions to pay for investment related goods and/or services from vendors.

In order to implement the use of commissions, CalSTRS established client directed arrangements with brokers, who agreed to allocate (based on a ratio), a portion of their commissions for CalSTRS' benefit. These credit balances with the third party brokers are used to defray CalSTRS' expenditures for various investment-related goods and/or services. The arrangement between CalSTRS' managers and the pool of third party brokers is referred to as a third party arrangement. Based on the credit balance of the third party brokers, and upon written authorization by CalSTRS, the broker pays for the authorized investment goods and/or services. Additionally, CalSTRS can request a rebate of these commissions (commission recapture).

C a I S T R S S O F T D O L L A R P R O G R A M



The Soft Dollar Program also includes the manager directed transactions whereby CalSTRS' external managers use soft dollars to acquire research or allowed services to facilitate managing the portfolio on behalf of CalSTRS. In all instances, regardless of whether it is a client directed or manager directed transaction the managers' primary objective is to provide "best execution".

CalSTRS SOFT DOLLAR PROGRAM:

In 1985 CalSTRS adopted a Soft Dollar Policy to set guidelines for the program. The last amendment to this policy was made in 1994. Although CalSTRS is not subject to Section 28(e) of the Securities and Exchange Commission (SEC) or the Employee Retirement Income Security Act of 1974 (ERSIA) the Investment Branch uses them as additional guidelines for the Program.

The conditions for the use of client directed commissions as defined in the current policy are as follows:

1. The goods or services are expenses that could otherwise be appropriately purchased by the System using hard dollars (cash);
2. The cost and volume of the services are reasonable and the benefits of these goods or services inure only the System;
3. Staff may direct a portion of the normal trading activity to brokers for reimbursement of third party services provided brokerage transactions are completed on a "best execution" basis;
4. The staff provides investment managers and brokerage firms with specific written instructions concerning the purpose and amount of payments for goods or services provided based on their cost to the System; and
5. The staff documents the cost and value of all soft dollar goods or services received and report to the Board at least once annually on the soft dollar costs of these goods or services.

Within CalSTRS' soft dollar program there are various processes followed to insure the validity of the program. These are:

Client directed

- annual approval of all investment goods and/or services to be purchased through commissions;
- annual report to the Board of all investment goods and/or services;
- monthly reconciliation of soft dollar commissions;
- periodic onsite visits to third party brokers;
- annual confirmation letters to all third party brokers to reconcile credit balances;
- periodic review of third party brokers.

Manager directed

- compliance certification
- monthly reporting and reconciliation
- periodic onsite visits

The Soft Dollar Program has been expanded to include non-US equity managers in addition to the domestic equity and fixed income portfolios. Improvement in distribution ratios, expanded participation of managers and brokers and increased flexibility in the selection of brokers have evolved the Program into an effective method of supporting the goals and objectives of the Investment Branch.

Attachment 1 is the soft dollar policy, which has been drafted to reflect changes in the Program and to parallel the other investment related policies in format.

RECOMMENDATION

Staff recommends approval of the Soft Dollar Policy with the adoption of the Resolution (Attachment 2).

CalSTRS

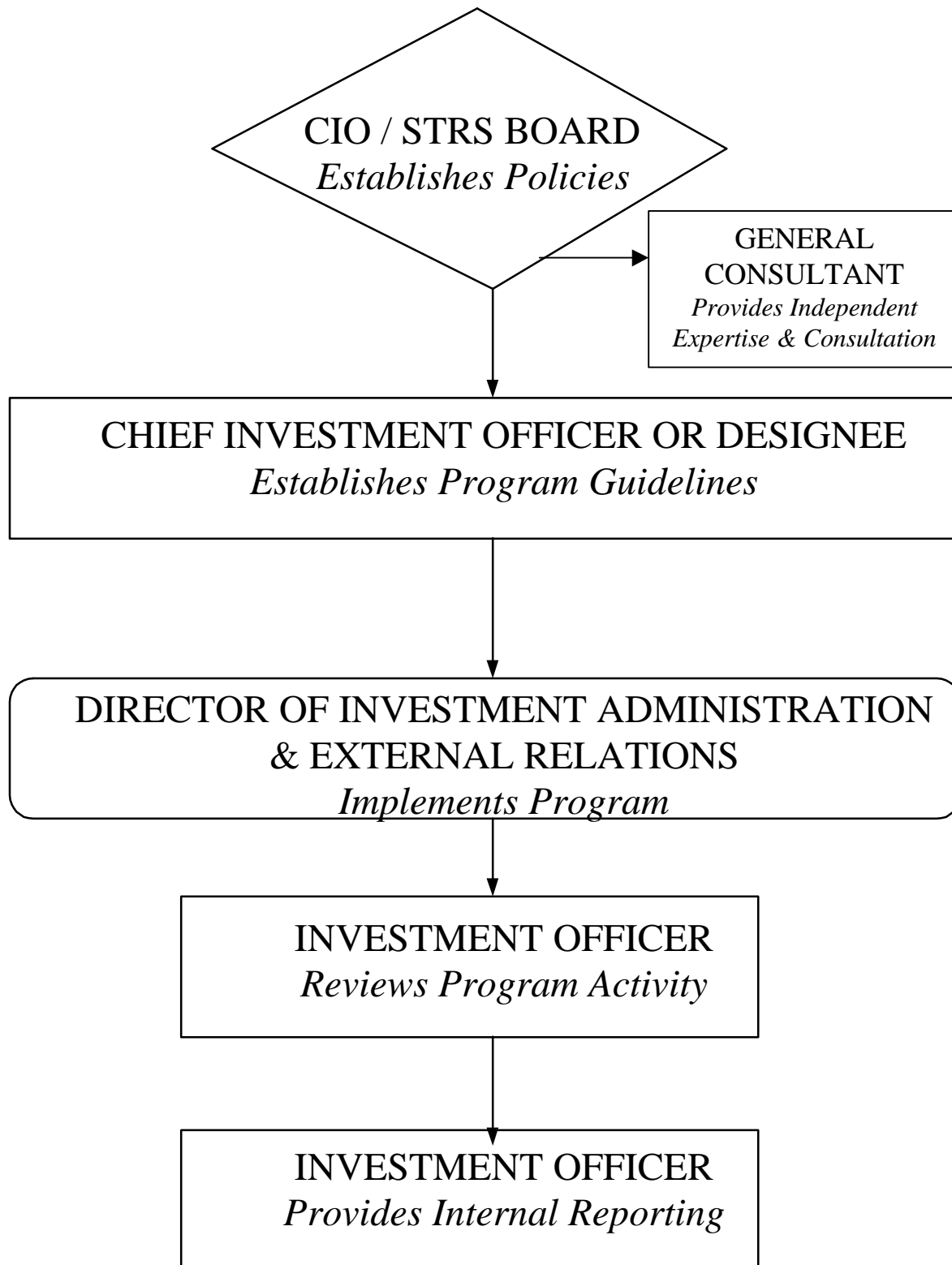
CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

SOFT DOLLAR PROGRAM POLICY MANUAL

INVESTMENT BRANCH

April, 1999

SOFT DOLLAR PROCESS



INTRODUCTION

In accordance with the direction of the Teachers' Retirement Board (Board), the California State Teachers' System (CalSTRS) participates in directed brokerage or soft dollar arrangements. In this policy the terms directed brokerage and soft dollars are considered synonymous and have been used interchangeably.

The term soft dollar arrangement developed as a result of the repeal of fixed commission rates. Prior to May 1975 commissions charged by brokers for trade execution were fixed by law. These fixed commission schedules set the commissions for large institutional trades at a high level. As a result the investment management industry sought ways to recapture portions of the commissions paid to brokers. During this period brokers typically provided research and other services to attract business because they could not compete on the basis of commission rates.

In 1975 the Security Exchange Commission (SEC) eliminated fixed commission rates. Congress ratified this action by adopting Section 6(e) of the Security and Exchange Act in the 1975 Amendments. After commission rates became negotiable and rates varied, concern arose that a fiduciary could be found to have breached its duty by not using the broker charging the lowest commission rate available. To address this concern Congress amended the Securities Exchange Act of 1934 to provide, a "safe harbor", Section 28(e). Section 28(e) provided that a fiduciary would not breach its duty when causing its clients to pay more than the lowest commission rate available if the fiduciary makes a good faith determination that the commission charges are reasonable in relation to the brokerage and research services provided by the broker. Section 28(e) applies only to security transactions executed on an agency basis.

The primary purpose of directed brokerage is to directly or indirectly compensate the brokerage industry for providing research. Providing research is one important, long-standing service of Wall Street brokerage businesses. Directed brokerage arrangements have developed as a link between the brokerage industry's supply of research and the money management and plan sponsor demand for research.

A secondary purpose is to directly compensate a third party for research products or services received by the plan sponsor. Because the commission dollars are an asset of the plan sponsor, the practice of client directed brokerage does not per se violate any investment advisor duties.

The fiduciary standards provided in law require that the Board, its officers, employees and other staff act prudently and solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable administrative expenses of CalSTRS. It is recognized that the generation of commissions is inherent to the execution function of the investment process. It is a widespread practice among pension plans to use a portion of these commissions to defray expenses which otherwise would have been incurred and paid for using budgeted funds.

In all soft dollar arrangements, the investment advisor must always act for the *EXCLUSIVE* benefit of its clients and place the clients' interest before its own.

SOFT DOLLAR PROGRAM POLICIES

The following represent the approved policies to be utilized in the management of the soft dollar program. The policies are designed to set boundaries for the expected performance and structure. Policies approved by the CalSTRS Board cannot be altered without explicit direction from the CalSTRS Board.

1. The soft dollar program of the CalSTRS is administered in a prudent manner for the sole benefit of CalSTRS participants and beneficiaries in accordance with the Teachers' Retirement Law and other applicable statutes.
2. At all times, the manager shall use best efforts and discretion to obtain the most favorable net results in executing trades for the CalSTRS account.
3. The administration of the CalSTRS soft dollar program is delegated to staff within the boundaries established by these policies and the processes described in the procedures.
4. CalSTRS' staff will monitor the external equity managers' use of soft dollars (manager-directed). Each manager will provide CalSTRS with documentation certifying compliance with the rules and regulations established by the Securities and Exchange Commission (SEC) for soft dollars.
5. CalSTRS (client directed) shall use soft dollars to compensate a third party for research, products or services which inure only to the System.
6. A pool of brokers will be established using predetermined criteria outlined in the soft dollar procedures to participate in the client directed CalSTRS program.
7. For the client directed soft dollar program, each broker may maintain balances. At CalSTRS direction these balances may be used to pay for approved third party research, products or services or the balances may be rebated (commission recapture) as described in the procedures.
8. Authorization letters will be sent to each broker identifying who may direct payments on behalf of CalSTRS. Any change to the authorized signers will be noticed in writing to the brokers within 24 hours in the event of change in personnel and as soon as possible in the event of a newly authorized signer(s).
9. The CalSTRS soft dollar program will be administered in accordance with an annual Business Plan which will include the program objectives which are consistent with the established policies.
10. The Investment Committee shall review this policy periodically as it deems appropriate.

DEFINITIONS

“Agency Trade” a trade in which the broker acts as agent and executes buy or sell for a customer. A commission is charged for the service.

“Agent” the role of a broker/dealer firm when it acts as an intermediary between its customer and another customer. For this service the broker receives a commission.

“Best Execution” refers to executing Client transactions so that the Client's *total cost* is the most favorable under the particular circumstances at that time.

“Broker” refers to a person or entity registered with the National Association of Security Dealers and provides investment services (research, soft dollars, etc) and/or execution services.

“Brokerage” refers to the amount on any trade retained by a Broker to be used directly or indirectly as payment for execution services and, when applicable, research supplied to the Investment Adviser or its Client in connection with Soft Dollar Arrangements or for benefits provided to the Client in Client-Directed Brokerage Arrangements. For these purposes, trades may be conducted on an agency or principal basis.

“Brokerage Arrangement” refers to an arrangement whereby a Broker provides services or products in addition to execution. Brokerage Arrangements include Investment Adviser-Directed and Client Directed Brokerage Arrangements.

“Brokerage and Research Services” refers to services and/or products provided by a Broker to an Investment Adviser through a Brokerage Arrangement, including trade execution; the furnishing of relevant advice relating to the purchasing and selling of securities; analysis and reports relating to relevant market information; and the performance of incidental functions, such as clearance, settlement and custody.

“Client” refers to the entity, including a natural person, investment fund or separate account designated to receive the benefits, including income, from the Brokerage generated through Securities Transactions. A Client may be represented by a trustee or other Fiduciary, who may or may not have Investment Discretion.

“Client-Directed Brokerage Arrangement” refers to arrangement whereby a Client directs that trades, for its account, be executed through a specific Broker in exchange for which the Client receives a benefit in addition to execution services. Client-Directed Brokerage Arrangements include rebates, commission banking and commission recapture programs through which the Broker provides the Client with cash or services or pays certain obligations of the Client. A Client may also direct the use of limited lists of broker-not for the purpose of reducing Brokerage costs, but to effect various other goals (e.g., increased diversity by using minority-owned brokers) or geographical concentration.

“Commission” refers to the amount paid to the Broker in addition to the price of the security and applicable regulatory fees, on an agency trade.

“Fiduciary” refers to any entity, or a natural person, including an AIMR Member, that has discretionary authority or responsibility for the management of a Client’s assets or other relationships of special trust.

“Hard Dollar” a term that refers to cash.

“Investment Decision-Making Process” refers to the quantitative and qualitative processes and related tools used by the Investment Adviser in rendering investment advice to its Clients, including financial analysis, trading and risk analysis, securities selection, broker selection, asset allocation and suitability analysis.

“Investment Discretion” refers to the sole or shared authority (whether or not exercised) to determine what securities or other assets to purchase or sell on behalf of a Client.

“Investment Adviser” refers to any entity, or a natural person, including an AIMR Member, that serves in the capacity of asset adviser to a Client. The Investment Adviser may have sole, shared, or no investment Discretion over an account.

“Mixed-Use” refers to services and/or products, provided to an Investment Adviser by a Broker through a Brokerage Arrangement that have the capacity to be used for both the Investment Decision-Making Process and management of the investment firm.

“Principal Trade” a trade in which the broker acts on his own behalf and buys or sells for a customer.

“Proprietary Research Arrangement” refers to an arrangement whereby the Investment Adviser directs a Broker to effect Securities Transactions for Client accounts in exchange for which the Investment Adviser receives Research from, and/or access to, the “in-house” staff of the brokerage firms.

“Provided by a Broker” refers to (i) in Proprietary Research Arrangements, Research developed by the Broker and (ii) in Third-Party Research Arrangements, Research for which the obligation to pay is between the Broker and Third-Party Research Provider, not between the Investment Adviser and Third-party Research Provider.

“Ratio” represents the number of commission dollars to cash (hard dollars) required to purchase services. Examples: if a service cost \$100 in cash, at a ratio of 1.8:1, the commission (soft dollar) cost would be \$180 or $1.8 \times 100 = \$180$.

“Research” refers to services and/or products provided by a Broker, the primary content of which must, if used by the Investment Adviser, directly assist the Investment Adviser in its Investment Decision-Making Process and not in the management of the investment firm.

“Section 28(e) Safe Harbor” refers to the "safe harbor" set forth in Section 28(c) of the U.S. Securities Exchange Act of 1934, which provides that an Investment Adviser that has Investment Discretion over a Client account is not in breach of its fiduciary duty when paying more than the lowest Commission rate available if it determines in good faith that the rate paid is commensurate with the value of Brokerage and Research Services provided by the Broker.

“Securities Transactions” refers to any transactions involving a Broker, whether conducted on an agency basis or principal basis.

“Soft Dollar Arrangement” refers to an arrangement whereby the Investment Adviser directs transactions to a Broker, in exchange for which the Broker provides Brokerage and Research Services to the Investment Adviser. Soft Dollar Arrangements include Proprietary and Third-Party Research Arrangements but do *not* include Client-Directed Brokerage Arrangements. Soft Dollar Arrangements are sometimes referred to herein as Investment Adviser-Directed Brokerage Arrangements.

“Third-Party Research Arrangement” refers to an arrangement whereby the Investment Adviser directs a Broker to effect Securities Transactions for Client accounts in exchange for which the Investment Adviser receives Research provided by the Broker, which has been generated by an entity *other than* the executing Broker.

PROPOSED
RESOLUTION OF THE
CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

Subject: Soft Dollar Policy

Resolution No. _____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the Soft Dollar Program Policies and has heard oral presentations from Staff; and

WHEREAS, the Staff has recommended the adoption of the Soft Dollar Program Policies; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board adopts the Soft Dollar Program Policies.

Adopted by:
Investment Committee
On April 7, 1999

James D. Mosman
Chief Executive Officer